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Market Volatility and Behavioral Pitfalls

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The eurozone sovereign debt crisis, anemic US economy, persistently high domestic unemployment and dysfunctional US Congress have all conspired to hurt business and consumer confidence, create crippling uncertainty and cause massive market volatility in the past few months. With short memories and sensational stories to tell, the media is trotting out adjectives like "unprecedented" to describe the seriousness of this volatility. Is it really "unprecedented"?

Below is a table from J.P. Morgan Asset Management which quantifies the largest intra-year market declines for each calendar year between 1980-2010. From the table you can see that we have endured nasty market drops (aka *negative* volatility) in most years covered by the table. While not apparent from the table, history shows that you also had to endure lots of interim ups and downs as these declines developed.

Largest Intra-Year Declines (1980-2010)

Year	'80	'81	'82	'83	'84	'85	'86	'87	'88	'89
Intra-year decline	***-17%***	***-17%***	***-14%***	***-7%***	***-12%***	***-8%***	***-9%***	***-34%***	***-8%***	***-8%***

Year	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99
Intra-year decline	***-20%***	***-6%***	***-6%***	***-5%***	***-9%***	***-3%***	***-8%***	***-11%***	***-19%***	***-12%***

Year	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09
Intra-year decline	***-17%***	***-26%***	***-32%***	***-14%***	***-8%***	***-7%***	***-8%***	***-10%***	***-47%***	***-28%***

Year	'10
Intra-year decline	***-16%***

Source: Standard and Poor's, FactSet, J.P. Morgan Asset Management Market Bulletin (8/7/11).
Market returns are based on S&P 500 Index price only and do not include dividends.

The current volatility is hardly unprecedented. The table shows that the worst intra-year drop was *negative* 47% in 2008, a year that was full of + and -3% market days. Over the past 31 calendar years, the intra-year drops ranged from *negative* 3% to *negative* 47%, with an average of *negative* 14.3%. Let's put this in perspective – the dreaded "bear market" is conventionally defined as a 20% decline. So the ***average*** intra-

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year decline of the past 31 calendar years was only about 5% short of a bear market. And more importantly, the market still managed positive annual returns in 24 of the past 31 calendar years despite these recurring and distressing intra-year declines. ***Put simply, there is a very high probability that the market will experience a nasty drop in any one year (punctuated by smaller interim ups and downs). Still, the odds are good that the market will end the calendar year producing positive returns.*** Keep this in mind next time you encounter a nasty market drop and the media proclaims the end of the world.

Most investment mistakes are behavioral in nature, often originating from our emotional reaction to market volatility. How you react to each recurring bout of volatility will determine to a large extent the long-term success you will have with your investments. Extensive research in the fields of finance and psychology has shown that we are naturally wired to want to "flee" or avoid such volatility. Many will repeatedly act on this natural impulse by selling securities, typically after they have already dropped a lot. In fact, studies have shown that those who try to dart in and out of their investments (stocks specifically) to mitigate volatility suffer around a 7% per year opportunity cost. That could be the difference between a comfortable and secure retirement and outliving your money.

There are at least two things you can do to deal with market volatility. ***The first is simply to give your investments time to work out. Market or security volatility diminishes substantially with the passage of time***. Market returns over any single calendar year can and do deviate substantially from the long-term average market return. Obviously, security prices during any period shorter than a year (e.g. a single day) will fluctuate even more, often for no good reason at all. Average annualized market returns over rolling 10-year periods are much more tightly bunched around the long-term market return average. ***This is a remarkably simple and powerful tool to deal with volatility – be patient and invest with a long-time horizon.***

Investing with a long-time horizon also allows your investments time to ***rebound***. J.P. Morgan Asset Management recently put out a "Guide to the Markets" that discussed how quickly some past market drops rebounded. Using the S&P 500 Index, on a price basis only, as the market proxy, the guide showed an average drop of *negative* 35% over the past ten bear markets. ***Interestingly, the number of years that the index took to rebound from a bear market low to the previous market peak ranged from 0.2 year to 5.8 years, with an average of 2.2 years***. Even after the recent declines, the market is still roughly 10 times higher than it was 40 years ago, despite the 5 bear markets it went through. So, ***typically it does not take that long for markets to rebound fully from bear markets***.

Since most investment mistakes are behavioral based, the second thing you can do to deal effectively with unsettling volatility is to be aware of some common behavioral pitfalls (discussed below) to which we are all vulnerable. This will help you maintain the appropriate reaction to volatility as well as make you a better investor.

Anchoring

Anchoring uses reference points that are misleading or irrelevant to make decisions. An example would be mistakenly thinking a stock must be undervalued if it has dropped a lot, let's say from $20 a share to $14 a share. Using $20 a share as reference to determine the stock's current valuation may be misleading if that former price was ridiculously high. Another example of anchoring is investors fixating on their purchase price for an investment, which has nothing to do with how much the stock might be worth going forward. Sometimes it is better to sell and move on rather than to wait for "break-even," if the company behind the stock is in permanent decline.

Right now, many investors have sworn off stocks for good because they are anchoring to the past decade's lousy stock returns and giving up hope. However, the history of the markets shows unequivocally that financial markets go in cycles. The more extreme a trend gets, the closer it is to an inflection point where the trend starts reversing. In contrast, investors tend to extrapolate current trends, when all evidence shows that markets regress towards a long-term mean. So instead of being discouraged by the "lost decade," it is more productive to adopt a broader historical perspective and expect regression towards the mean at some point, which suggests above-average returns for the market in the next 10 years.

Confirmation Bias

Confirmation bias refers to making a decision and then looking for ***only*** data or information that support rather than refute your thesis. An example would be you ignoring all negative news affecting a stock that you own. Because it is natural for us to seek out conforming opinions, it is especially important to fight this natural tendency by examining evidence that contradicts your views, such as contra-cases presented by short-sellers of your stock.

Another example would be you thinking it is a good time to sell a stock, and seeking only information that supports your decision. Given all the media coverage these days on how much further stocks will fall, it is too easy to be bearish and look for only negative news or stories to back this up.

Recency Bias

Recency bias is the tendency to focus more heavily on recent events while ignoring the lessons of the past. Rather than making decisions with a longer term perspective, this bias leads you to put more weight on recent events. This is one of the main reasons investors tend to buy high and sell low. When tech stocks with little or no earnings were hot in the late 1990s, investors piled into them with a view that they would enjoy unlimited growth that justified their absurd valuations even though a historical perspective would have better informed investors of the bubble developing.

Likewise, during the 2008-2009 meltdown, many investors thought the financial markets would never rebound and pulled billions of dollars from stock mutual funds, in the face of a long history demonstrating the market's resiliency over time. These investors missed out on the subsequent robust rebound in the stock market, doing significant damage to their long-term financial security. Likewise, it is natural for us to be caught up in the current relentless negative news cycle and be tempted to sell all our investments. Broadening your perspective and taking into account market history will help you understand and accept that volatility is always present in the stock market, which has gone up over time despite recurring volatility, recessions, natural disasters, wars, geopolitical crises, and other negative events.

Loss Aversion

Ample research in the field of psychology shows that most of us are loss averse, meaning that the pain we suffer from losing is about twice as intense as the joy from winning. This has all sorts of important implications for investing. One common behavior stemming from loss aversion is that investors are much more willing to realize gains by selling winning stocks (because they don't want to lose those profits and suffer regret). On the other hand, they are very reluctant to sell and realize losses, waiting instead for break-even. This ties up capital that can be more profitably deployed elsewhere.

Another example of loss aversion is when investors incessantly worry about a position in the portfolio that is going down, but which has a negligible effect on the portfolio. Such investors spend an inordinate amount of time obsessing about this one position at the expense of tending to other more important positions in the portfolio.

Loss aversion can often lead to panic when markets are dropping, even though you may not need the money and should welcome lower prices to buy in. The fear of further losses is so great that investors panic out of the market. It may cause people to put too much into bonds and cash and not enough into stocks. Consequently, over a typical retirement period of 30+ years, invested savings fail to keep up with inflation. Also, loss aversion often leads to the most intense selling of stocks near market bottoms.

Herding

Herding is a form of behavior that follows and finds comfort in consensus. Consensus is good for many human and social endeavors, but lethal when it comes to investing. If there is a consensus about a stock, people have already acted, and the price already reflects that fact. Psychologically, we seek out comfort and safety in numbers, especially when we face situations of great uncertainty and serious consequences. Investing involves precisely such uncertainty and consequences.

Fear and greed are human traits that will always be with us; the herding effect tends to worsen these trends once established. In a sense, believing the market is always roughly right in pricing securities is the biggest herding trade ever, because you are substituting a lot of people's judgment for your own. Performance chasing is another harmful herding activity. Professional investment managers are some of the worst herding offenders; they herd to avoid criticism. They think it is ok to mess up, as long as they act like their peers and competitors.

Media is notorious for promoting herding, often by mindlessly reinforcing consensus viewpoints. Shows like CNBC are mostly entertainment; it is fun as long as you see it for what it is. But a lot of financial writers and journalists, whether in print, online or broadcast, don't know their subject very well. Since misinformation is being disseminated on a daily basis, it is important to separate what is helpful from what is damaging in order to keep ourselves from falling into the traps of euphoric buying at high prices and panic selling at depressed prices.

It is difficult to fight human nature. When the markets are swamped with negative news and experiencing sharp declines, it is natural for you to feel a need to change your investment plan. But historic data show that market volatility is normal and can be expected every year; the stock market has rebounded every time, through wars, corporate bankruptcies and a host of other challenging events. Falling victim to behavioral mistakes could significantly hurt your financial situation in the long run. This is why it is crucial for you to maintain a proper perspective beyond "the here and now" and remain disciplined with your long-term investment strategy notwithstanding inevitable bumps along the way.